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No. 90-1851

Supreme Court, U.S.
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In the Supreme Court of the United States

OCTOBER TERM, 1991

STEPHEN ADAMS, PETITIONER

v.

RESOLUTION TRUST CORPORATION, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF FOR THE RESPONDENTS IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner is entitled to rescind his purchase of subordinated securities from a now insolvent thrift institution where the purchase agreement and the applicable regulations indicated that the securities would be used to meet the institution's regulatory capital requirements.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-28a) is reported at 927 F.2d 348. The February 9, 1990, order of the district court (Pet. App. 70a-97a) is reported at 731 F. Supp. 352. The February 23, 1990, order of the district court (Pet. App. 98a-100a) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on February 28, 1991. The petition for writ of certiorari was filed on May 29, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. The Federal Home Loan Bank Board formerly served as the principal regulator of federally chartered thrift institutions.[1] Among other matters, the Bank Board specified terms and conditions under which thrift institutions could issue subordinated debt securities. See 12 C.F.R. 563.8-1 (1988). On December 21, 1987, the Bank Board approved a request from Midwest Federal Savings and Loan Association (MWF), a federally insured savings institution, to issue up to $25 million in MWF subordinated debt securities. Petitioner, Stephen Adams, purchased $2.5 million of those securities from MWF through a private offering. Petitioner financed his investment with the proceeds from a promissory note with MWF that he executed on the same day. Shortly after the consummation of the sale, MWF applied the securities to its regulatory capital. Pet. App. 4a-5a, 8a-9a, 72a.[2]

Petitioner and MWF entered into a "Subordinated Debt Securities Agreement" at the time of the purchase. The Agreement gave petitioner certain limited

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[1] The Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, abolished the Bank Board and replaced it with the Office of Thrift Supervision, §§ 301, 401, 103 Stat. 278, 354; see 12 U.S.C. 1462a (Supp. I 1989).

[2] Federally chartered financial institutions must meet federally prescribed capital requirements. Under the Bank Board's regulations, regulatory capital included reserve accounts, retained earnings, permanent common stock, securities constituting equity capital, appraised equity capital, and any other nonwithdrawable reserve accounts that could be used to satisfy the claims of depositors and other account holders. Pet. App. 9a n.6. The Bank Board also included subordinated debt securities as regulatory capital pursuant to 12 C.F.R. 561.13(c)(1) (1988). See Pet. App. 9a n.6.

remedies in the event of MWF's default.[3] First, it provided that petitioner could accelerate payment in the event of default only to the extent that such payment did not leave MWF with insufficient capital to meet regulatory capital requirements set out in 12 C.F.R. 563.13 (1988). Second, it stated that if the Federal Savings and Loan Insurance Corporation (FSLIC) were appointed as a receiver for MWF, FSLIC would not have any obligation to arrange for the assumption of the securities.[4] Third, it provided that petitioner agreed to abide by the Bank Board's priority regulations governing the distribution of assets in receivership proceedings. Both the security instruments themselves and the Agreement expressly provided that, in the event MWF were liquidated, petitioner's interests would be subordinated to claims of savings account holders and to all other claims having a priority equal to or greater than that of savings account holders. Pet. App. 5a-8a, 75a-77a.

2. In January 1989, the Bank Board concluded that MWF had improperly treated the securities issued to petitioner as regulatory capital, because petitioner had purchased them with unsecured funds borrowed from MWF. The Bank Board ordered MWF prospec-

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[3] The Agreement defined default by MWF to include the failure to make timely payments of interest or principal, the declaration of insolvency and appointment of a conservator, receiver or liquidating agent, and any false representations or warranties made by MWF in connection with the contemplated transactions. Pet. App. 5a-6a.

[4] Congress has since abolished FSLIC. See FIRREA, § 401(a), 103 Stat. 354. The Resolution Trust Corporation (RTC) assumed the FSLIC liquidation function for all savings and loan institutions placed in conservatorship or receivership after January 1, 1989. FIRREA, § 501(b)(3)(A), 103 Stat. 369, 12 U.S.C. 1441a(b)(3)(A) (Supp. I 1989).

tively to cease treating the securities as such. On February 13, 1989, the Bank Board declared MWF insolvent and appointed the FSLIC as conservator for the institution. On March 21, 1989, petitioner filed a complaint in state court against MWF and its officers alleging that MWF's misrepresentations at the time of the sale violated both federal and state securities laws. Petitioner asked the court to rescind the securities sale and to allow a set-off of the amount that MWF owed him for the securities against his obligation to MWF under the outstanding promissory note. He also asserted state law remedies for fraud. Pet. App. 10a-12a, 73a.

On May 4, 1989, the Bank Board determined that MWF remained insolvent, and it appointed FSLIC as receiver pursuant to 12 U.S.C. 1464(d)(6)(A) and 12 C.F.R. Pt. 547 (1988) for the purpose of liquidating the institution. The Bank Board also found that the total liquidation of MWF could not generate sufficient funds to satisfy the claims of MWF's general creditors, and it therefore determined that all equity and subordinated debt interests in MWF were worthless.[5] To effectuate the liquidation, the Bank Board created a new institution, Midwest Savings Association (Midwest), and immediately placed it into conservatorship. The Bank Board then directed FSLIC to enter into a purchase and assumption agreement with Midwest by which the majority of MWF's assets were transferred to Midwest in consideration for Midwest assuming certain liabilities of the failed institution. Under the agreement, Midwest did not

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[5] Under the FSLIC priority scheme, subordinated debt holders were paid only after all other creditors, except equity interest holders, were paid. 12 C.F.R. 569c.11 (1989). See Pet. App. 8a n.5.

assume any MWF subordinated debt or equity liabilities or obligations. As a result, Midwest received petitioner's promissory note while FSLIC, as receiver for MWF, retained MWF's obligations on the securities. Pet. App. 12a-14a, 73a-74a.

3. Petitioner's pending civil action was removed to the United States District Court for the District of Minnesota. Pet. App. 73a n.3. The Resolution Trust Corporation (RTC) thereafter assumed FSLIC's conservatorship and receivership responsibilities. RTC, acting as conservator for Midwest and receiver for MWF, sought to dismiss petitioner's claims seeking rescission of the securities transaction and a set-off against the promissory note. On February 9, 1989, the district court granted summary judgment for RTC. *Id.* at 70a-97a. The district court concluded that petitioner was estopped from rescinding his purchase because petitioner presumptively knew that the securities were used to increase MWF's regulatory capital, and the court concluded that petitioner was not entitled to a set-off because the securities and the promissory note were not mutual obligations. *Id.* at 80a-90a. The district court also dismissed petitioner's state-law based statutory and common law claims. *Id.* at 90a-94a.[6]

4. The court of appeals affirmed the district court's decisions, Pet. App. 1a-28a, relying on its decision,

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[6] Petitioner also filed a separate, but related, action against FSLIC in its corporate capacity alleging that FSLIC's purchase and assumption agreement was unlawful and that he was entitled to pro rata distribution. Pursuant to FIRREA, the Federal Deposit Insurance Corporation (FDIC) was substituted for FSLIC with respect to that claim. See FIRREA, § 401, 103 Stat. 354. On February 23, 1990, the district court dismissed that action based on its reasoning in the prior action. Pet. App. 98a-100a.

filed the same day, in *Northwest Racquet Swim & Health Clubs, Inc.* v. *RTC*, 927 F.2d 355, petition for cert. pending, No. 90-1825 (filed May 28, 1991). The court explained that "where investors in a federally regulated institution subordinate their claims in such a manner as to make the investments eligible for use as regulatory capital, and where the issuing institution applies such investments to regulatory capital, the investments must be regarded as fully encumbered by the regulatory obligation to remain subordinate to the claims of depositors and general creditors in the event of insolvency." Pet. App. 20a. Thus, once MWF was declared insolvent, petitioner could not rescind his obligation and share in any pro rata distribution with MWF's general creditors. *Id.* at 22a. The court also affirmed the district court's dismissal of petitioner's other claims. *Id.* at 22a-27a.

ARGUMENT

The court of appeals correctly affirmed the district court's determination that petitioner was not entitled to a rescission or set-off of the subordinated debt obligation. The court's decision rests on the application of established law to the facts of this case and does not conflict with any decision of this Court or another court of appeals. Further review is accordingly unwarranted.[7]

1. The court of appeals correctly applied its decision in *Northwest Racquet* to the essentially identical facts of this case. See Pet. App. 19a-23a. That decision holds that where a federally regulated financial institution has issued a subordinated debt security to meet regulatory capital requirements, an investor

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[7] The same issue is presented in the petition for a writ of certiorari in *Northwest Racquet Swim & Health Clubs, Inc.* v. *RTC*, No. 90-1825.

cannot rescind his purchase of the security once the institution becomes insolvent and the reserved capital must be called upon to satisfy the demands of unsubordinated creditors. See 927 F.2d at 362. In reaching that conclusion, the court of appeals properly followed the Second Circuit's decision in *In re Weis Securities, Inc.*, 605 F.2d 590 (1978), cert. denied, 439 U.S. 1128 (1979).[8]

2. Petitioner mistakenly contends (Pet 26-30) that the court of appeals' decision is inconsistent with this Court's decision in *Oppenheimer* v. *Harriman Nat'l Bank & Trust Co.*, 301 U.S. 206 (1937). In *Oppenheimer*, this Court permitted a shareholder of a national bank to maintain his action for rescission, but *only* after he had paid his statutory liability to other creditors pur-

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[8] In *Weis*, a securities broker borrowed money to meet the securities industry's regulatory capital requirements. The lenders subordinated their loans to the claims of other creditors in exchange for a higher rate of return. When the broker became insolvent, the lenders sought to rescind the loan agreements based—as here—on claims of fraudulent inducement. The Second Circuit held that the lenders were not entitled to post-insolvency rescission, because the loans were applied to meet regulatory capital requirements and the lenders were estopped, by their acceptance of their subordinated status, to make post-insolvency challenges to that status. 605 F.2d at 596-597.

The same principle applies in this case. As the court of appeals explained, the regulatory capital requirements of the thrift industry, like those in the securities industry, are designed to protect the interests of the unsubordinated creditors. *Northwest Racquet*, 927 F.2d at 360-361. That protection would be similarly undermined if an investor who purchases a thrift institution's subordinated debentures may rescind his agreement and compromise the associated capital reserves once insolvency occurs. Cf. *Scott* v. *Deweese*, 181 U.S. 202 (1901) (holding that an equity shareholder of a national bank who alleged fraud in the inducement may not obtain a post-insolvency rescission of his subscription).

suant to 12 U.S.C. 63 (1958) (repealed 1959). *Oppenheimer*, 301 U.S. at 211. The Court explained that the "[p]laintiff appeared by the bank's records to be a stockholder and, as against creditors for whose benefit the statutory liability was created, was estopped from denying that status." *Id.* at 214 & n. 14 (citing *Scott* v. *Deweese*, 181 U.S. 202 (1901)). The Court concluded, however, that "having fully paid his liability to the creditors, there is no reason why his claim should be subordinated to claims of stockholders on account of their deposit balances when the bank failed." *Id.* at 215. Thus, the court of appeals' decision follows *Oppenheimer*'s underlying rationale that where an investor in an insolvent institution owes a legal obligation to the institution's general creditors, the investor must satisfy that obligation before it can rescind its investment.[9]

Petitioner also argues (Pet. 33-37) that the court of appeals' decision "distorts" the Second Circuit's decision in *Weis* because "the *Weis* investors *knew* that the broker-dealer was in precarious financial circumstances and their loans were being used to satisfy the regulators" (*id.* at 34). The court of appeals correctly rejected that argument in its *Northwest Racquet* decision. The court acknowledged that "the specific intention of the lenders in *Weis* was a factor in the Second Circuit's decision," but further explained that the

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[9] Petitioner suggests that *Oppenheimer* stands for the proposition that "unless Congress 'unquestionably' demonstrates an intention not to allow investors to rescind fraudulently induced investments, they have that right." Pet. 30. Both the Eighth and the Second Circuits, however, have rejected that argument. See *Northwest Racquet*, 927 F.2d at 362 n.17; *Weis*, 605 F.2d at 596 n.12. No other court of appeals has considered the matter. Thus, even if there were merit to petitioner's argument, the question is not ripe for this Court's resolution.

Second Circuit's rationale "extends to situations in which parties subordinate their claims in such a manner as to make the investments eligible for use as regulatory capital." 927 F.2d at 362. "Any other result would undermine the regulatory protections and priorities accorded innocent third parties who rely upon stated capital reserves." *Ibid.*[10]

Petitioner is also mistaken in contending (Pet. 37 n.7) that the court of appeals' decision conflicts with the Ninth Circuit's decision in *FDIC* v. *United States Nat'l Bank*, 685 F.2d 270 (1982). In that case, the court permitted a defrauded subordinated debenture holder to rescind its purchase, because there was no evidence that the debentures were used as regulatory capital. 685 F.2d at 274. Indeed, the statute and regulations that applied in that case did not permit subordinated loans to be used as regulatory capital. *Id.* at 274-275. Hence, the Ninth Circuit's decision does not conflict with the court's decision in this case. See *Northwest Racquet*, 927 F.2d at 363 n.20

3. Petitioner also argues (Pet. 40) that the court of appeals' decision deprives investors of "any realistic remedy." As the court expressly stated in *Northwest Racquet*, however, its decision does not affect an investor's remedies prior to a declaration of insolvency. 927 F.2d at 363. And contrary to petitioner's assertions (Pet. 40-43), there is no reason to believe that the court's decision will "impair the ability of surviving thrifts to raise capital." Indeed, petitioner's ap-

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[10] Here, petitioner was clearly on notice that his investment would be applied to regulatory capital requirements. See Pet. App. 20a-21a, 88a-89a. Compare *Weis*, 605 F.2d at 595 ("one who purchased bank shares must be conclusively presumed to have known that he had increased the bank's capital and had facilitated its conduct of business" (citing *Scott* v. *Deweese*, 181 U.S. at 212)).

proach would result in thrifts raising reserved capital that simply vanishes, through rescission, upon a declaration of insolvency. The court's decision, by contrast, will provide greater prospects that a thrift's stated capital reserves will actually be available to meet the thrift's obligations to its creditors, and it will encourage investors to make prudent inquiry before investing in subordinated debt.[11]

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[11] There is no merit to petitioner's argument (Pet. 31-33) that the court of appeals' "real rationale" in this case was to protect the government at the expense of a private party. The court's "real rationale" is the rationale set forth in the panel's unanimous opinion. Similarly, there is no merit to petitioner's rhetoric (Pet. 38-40) that the court of appeals has allowed the federal government to "complete" MWF's alleged fraud. The court of appeals' decision simply gives effect to the expectations of *all* general creditors, both public and private, that their claims will remain superior to subordinated claims.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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